

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFPH:NEW:POSTS149059-01
PYTaylor

date: January 29, 2002

to: Territory Manager, Retailers Food Pharmaceutical & Healthcare
attn: Revenue Agent Steve Dacey

from: Associate Area Counsel
(Food, Retailers, Pharmaceutical & Healthcare)

subject: [REDACTED]
Taxable Years [REDACTED] - [REDACTED]
U.I.L. No. 162.06-01

This is a revised memorandum to replace our earlier advice. This memorandum incorporates changes recommended by our National Office. This memorandum should not be cited as precedent.

Issues

1. Whether expenses incurred by [REDACTED] for the investigation of new business markets and start-up costs of entry into those markets are ordinary and necessary expenses pursuant to section 162.
2. Whether section 482 should be applied because the taxpayer failed to use a reasonable method for determination of direct and indirect costs, pursuant to section 1.482-2, with regard to its "cost-plus" agreements with its foreign subsidiaries.

Background

[REDACTED] () formed [REDACTED] () on [REDACTED]. [REDACTED] entered into a service agreement with [REDACTED] on [REDACTED]. Under the terms of the agreement [REDACTED] would perform the following functions: obtain regulatory approval, perform [REDACTED] identification, perform [REDACTED], [REDACTED] and coordinate distribution. For these services [REDACTED] agreed that [REDACTED] would be reimbursed at cost plus [REDACTED].

On [REDACTED], [REDACTED] entered into a marketing and distribution agreement with [REDACTED]. This agreement provides that [REDACTED] as a distributor, will use its best efforts to establish [REDACTED] products in the market, fulfill market demand, and meet the marketing and distribution goals established by [REDACTED]. [REDACTED] agreed to assume inventory risks, credits risks, foreign currency risks and certain marketing risks. [REDACTED] received regulatory approval in [REDACTED].

to sell [REDACTED]'s products. While [REDACTED] takes title to the products, the transfer price is set in such a way that net profit to [REDACTED] will not exceed [REDACTED]% of sales. The legal title to the regulatory approvals belongs to [REDACTED] due to foreign legal requirements of the [REDACTED]. No royalties are paid by [REDACTED] to [REDACTED] under the agreement for the use of any intangibles.

[REDACTED] paid service fees to [REDACTED] for regulatory approval expenses as follows: \$[REDACTED] for [REDACTED], \$[REDACTED] for [REDACTED], and \$[REDACTED] for [REDACTED]. The agents classified regulatory approval expenses as pre-distribution start-up costs incurred to gain approval to distribute products in the relevant markets. The total service fees, paid by [REDACTED] to [REDACTED] are as follows:

Year	[REDACTED]	[REDACTED]	[REDACTED]
Sales/Marketing	[REDACTED]	[REDACTED]	[REDACTED]
G&A	[REDACTED]	[REDACTED]	[REDACTED]
R&D	[REDACTED]	[REDACTED]	[REDACTED]
subtotal	[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]%	[REDACTED]	[REDACTED]	[REDACTED]
Exchange rate	[REDACTED]	[REDACTED]	[REDACTED]
Total Service Fees	\$ [REDACTED]	\$ [REDACTED]	\$ [REDACTED] ¹

The agent also classified the expenses of [REDACTED] and [REDACTED] as pre-distribution start-up expenses.

Forms 5471 for subsequent years were inspected. [REDACTED] reimbursed the following percentages of [REDACTED]'s costs for general and administrative expenses, research and development and sales and marketing, through service fees:

Year	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]

Law and Analysis

Section 162 and Treas. Reg. section 1.162-1(a) of Income Tax Regulations generally allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. To qualify as an allowable deduction under section 162(a) an item must : (1) Be paid or incurred during the taxable year; (2) be for carrying on any

¹ These computations do not appear to be correct. Please verify through your work papers.

trade or business; (3) be an expense; (4) be a necessary expense; and (5) be an ordinary expense. *Commissioner v. Lincoln Savings & Loan Association*, 403 U.S. 345 (1971). In *Commissioner v. Tellier*, 383 U.S. 687 (1966), the Court stated that "the principal function of the term "ordinary" in section 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset." An expenditure is capital if it creates or enhances a separate or distinct asset. *Comm. v. Lincoln Savings*.

Section 263 and Treas. Reg. section 1.263(a) provide that no deduction is allowed for any amount paid out for permanent improvements or betterments made to increase the value of any property or estate. Section 1.263(a)-2(a) provides that capital expenditures include the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

In *Briarcliff Candy Corp. v Commissioner*, 475 F.2d 775 (2nd Cir. 1973), the court looked at costs incurred by a company to develop new local markets for its products by contracting with local stores to display its goods. The court held that the taxpayer's expenditures for expanding into a new market were deductible under section 162 because they did not create a new asset. These costs enhanced an existing asset, even though the benefits may last over a year.²

Section 195 provides that start-up expenditures may not be deducted but that a taxpayer may amortize such start-up expenditures which, if paid or incurred in connection with the operation of an existing active trade or business, would be deductible under section 162. Section 195 was added in 1980 in an effort by Congress to encourage formation of new businesses and to reduce controversy. Congress recognized that ordinary and necessary costs, incurred in the context of an expansion, were deductible under section 162. The legislative history provides:

In the case of an existing business, eligible start-up expenditures do not include deductible ordinary and

²See also *Colorado Springs National Bank v. U.S.*, 505 F.2d 1185 (10th Cir. 1974) (start-up costs incurred to join a new credit card system are a new method of doing business not a new business); *NCNB Corp v. U.S.*, 684 F.2d 285 (4th Cir. 1982) (costs incurred to add bank branches are currently deductible).

necessary business expenses paid or incurred in connection with an expansion of the business. As under present law, these expenses will continue to be currently deductible. The determination of whether there is an expansion of an existing trade or business or a creation or acquisition of a new trade or business is to be based on the facts and circumstances of each case as under present law.³

This legislative history is viewed as recognizing the viability of the *Briarcliff* case, with respect to the current deductibility of expansion costs of an existing business.

In *Indopco, Inc. V. Commissioner*, 503 U.S. 79 (1992), the Supreme Court held that certain legal and professional fees incurred by a target corporation to facilitate a merger created significant long-term benefits for the taxpayer and, thus, were capital expenditures. The Court rejected the contention that its earlier decision in *Commissioner v. Lincoln Savings* should be read as holding that only expenditures that create or enhance separate and distinct assets are to be capitalized.

The IRS does not appear to view the *Indopco* case as overturning the *Briarcliff* case.⁴ In Rev. Rul. 2000-4, 2000-1 C.B. 331, the Service looked at whether costs incurred by a taxpayer to obtain, maintain, and renew ISO 9000 certification are deductible as ordinary and necessary expenses under section 162. ISO 9000 is a series of international standards for quality management systems intended to ensure a quality process in providing services or products to an organization's customers. These costs may include costs to assess current quality processes, create a quality manual, train employees, and implement new systems. The ruling distinguishes ISO certification costs from costs incurred to obtain licenses and similar market-entry requirements.

The ruling concludes that benefits of ISO 9000 certification are similar to those derived from advertising and training incurred to retain or attract customers. As such, ISO 9000

³H.R. Rep. No. 1278, 98th Cong., 2d Sess. 11 (1980); S. Rep. No. 1036, 96th Cong., 2d Sess. 12 (1980).

⁴See TAM 9645002, wherein the IRS advised the certain costs incurred by a taxpayer in expanding a retail chain of stores are currently deductible. In footnote 2, the TAM states that the expansion occurred in the same state where the taxpayer already had stores.

certification does not result in future benefits that are more than incidental. The ruling provides that ISO certification costs are not deductible under section 162 if they result in the creation or acquisition of an asset having a useful life substantially beyond the taxable year. The ruling further concludes that even if ISO 9000 certification facilitates the expansion of the taxpayer's business, the mere ability to sell in new markets and to new customers, without more, does not result in significant future benefits.⁵

Start-up expenditures mean amounts incurred in connection with: (1) investigating the creation of a business, or (2) creating such business, or (3) an activity engaged in for profit before the business begins, and which, if incurred in connection with the operation of an existing business would be allowable as a deduction. IRC section 195(c)(1)(A)&(B). Investigatory expenses are costs of seeking and reviewing prospective businesses prior to reaching a decision to acquire or enter any business, such as analysis or surveys of potential markets, facilities or labor supply. The taxpayer formed subsidiaries and entered into service agreements in [REDACTED]. The current audit cycle is [REDACTED] to [REDACTED]. Typically, investigatory expenses would have been incurred prior to the current audit cycle.


Start-up costs are generally incurred after a decision to enter a business has been made but prior to actual operation of the business. The agent specifically identifies the regulatory

⁵ See FSA 1999-492, wherein the IRS advised that business expansion costs incurred in developing a variable universal life insurance product may be a capital expenditure because it was a new trade or business. The IRS commented on the following business expansion fact scenarios: (1) expansion of existing services/products into new markets, (2) introduction of new services/products into existing markets, (3) expansion of new services/products into new markets (services/products of the same generic type as existing services/products), (4) introduction of entirely different services/products into existing markets, and (5) introduction of entirely different services/products into new markets. The IRS further advised that "capitalization may be required in any of the five fact scenarios. However, in most instances, capitalization is more likely to be required in scenarios (3), (4), and (5). In scenarios (1) and (2), the facts of each particular case must be scrutinized very closely before a determination can be made." See also FSA 200109001, wherein the IRS advised that investigatory expenses incurred to expand a trade or business are deductible.

approval costs as a pre-distribution start-up expense. Regulatory approval is necessary to market and distribute the taxpayer's product in the new market. If the regulatory approval creates a long term benefit (akin to a license, entry fee or admission charge), there is a very good argument for requiring capitalization of the approval costs. If the regulatory approval has a determinable useful life, the costs would be amortizable over such useful life. If the regulatory approvals properly belong to the subsidiaries and not to the parent corporation there is a strong argument that such costs cannot be deducted or amortized by the parent.

With regard to the service fees incurred in this case, there are two main issues: (1) whether any of such expenditures can be seen as creating significant (rather than incidental) long-term benefits; and (2) whether any of such expenditures are non-deductible pre-distribution start-up costs. The latter issue depends upon a determination of whether there was merely an expansion of an existing business or the creation of a new business.

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In addition, since the subsidiaries are separate legal entities, there is a question as to whether the taxpayer can deduct these expenses. Generally, courts have held that to be deductible under section 162, the expense must be incurred in the taxpayer's own trade or business, not on behalf of another taxpayer.⁶ An exception to this rule was explained in *Lohrke v. Commissioner*, 48 T.C. 679 (1967). In *Lohrke*, the court held that a taxpayer may deduct the expenses of another taxpayer where the payment of the business expenses of another serves to promote or protect the taxpayer's own business. To satisfy this test, a taxpayer must show that the motive for paying another's expense was in furtherance (protection or promotion) of its trade or business, and the expenses are ordinary and necessary expenses in the furtherance of the taxpayer's trade or business.⁷ Again,

⁶See *Interstate Transit Lines v. Commissioner*, 319 U.S. 590 (1943).

⁷The *Lohrke* case dealt with the protection of an existing business. See also *Young & Rubicam, Inc. v. United States*, 410 F.2d 1233, 1237-1239 (Ct. Cl. 1969); *Specialty Restaurants Corp. v. Commissioner*, T.C. Memo. 1992-221, dealing with promotion of an

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we assume that the expenses incurred are the expenses of the taxpayer, there is the further requirement that they be at arms length.⁸ In this case, the arms-length nature of the service, marketing and distribution, and research and development agreements between the taxpayer and subsidiaries has been accepted by the agent. Thus, there remains an issue of whether there has been a proper identification and/or allocation of costs under the agreements.

Section 482 provides that the Secretary may distribute, apportion or allocate gross income, deductions, credits or allowances between or among organizations, trades or businesses to prevent evasion of taxes or clearly to reflect income. The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer. Section 1.482-2(b) provides, in part, that:

Where one member of a group of controlled entities performs marketing, managerial, administrative, technical, or other services for the benefit of . . . another member of the group . . . at a charge which is not equal to an arm's length charge . . . the district director may make appropriate allocations to reflect an arm's length charge for such services.

Section 1.482-2(b)(4) further provides that where an arm's length charge for services is determined by reference to the costs incurred with regard to such services (e.g. a cost-plus agreement as in this case), the direct and indirect costs must be determined on a reasonable basis. Direct costs, or deductions, are those identified specifically with a particular service. Indirect costs are those costs not specifically identified with a service or activity such as utilities, occupancy, supervisory and clerical compensation and other overhead departmental costs. In addition, an appropriate share of costs for supporting departments and applicable general and administrative expenses should be included. Indirect costs must be allocated to the services at issue on some reasonable basis.

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existing business.

⁸See *Bone v. Commissioner*, 81 T.C.M. 1199 (2001); *JRJ Express Inc. v. Commissioner*, 73 T.C.M. 2397 (1998).

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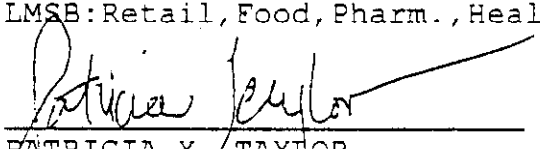
Recommendation

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